

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 02-0023
Sales and Use Tax
For the Years 1998-1999

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ISSUE

I. Sales and Use Tax- Computer Software

Authority: IC 6-2.5-2-1, IC 6-2.5-3-2, IC 6-8.1-5-1 (b), Sales Tax Information Bulletin # 8, February 9, 1990.

The taxpayer protests the imposition of the use tax on computer software.

II. Sales and Use Tax-Graphics Design Purchases

Authority: IC 6-2.5-5-4, 45 IAC 2.2-5-8 (c).

The taxpayer protests the imposition of tax on certain graphics design purchases.

III. Sales and Use Tax- Labels and Labeling Equipment

Authority: IC 6-2.5-5-6, IC 6-2.5-5-3 (b), 45 IAC 2.2-5-14(e).

The taxpayer protests the imposition of tax on certain labels and labeling equipment.

IV. Sales and Use Tax-Materials Handling System

Authority: IC 6-2.5-5-3, 45 IAC 2.2-5-8 (d), 45 IAC 2.2-5-8 (f)(1).

The taxpayer protests the imposition of tax on the materials handling system.

V. Tax Administration- Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2.

The taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

The taxpayer operates a manufacturing facility producing a variety of injection-molded plastic products. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional sales and use tax, interest, and penalty. The taxpayer protested this assessment and a hearing was held.

I. Sales and Use Tax- Computer Software

DISCUSSION

Indiana imposes a sales tax on retail transactions made in Indiana. IC 6-2.5-2-1. A complementary use tax is imposed on personal property purchased in a retail transaction and used in Indiana when no sales tax has been paid. IC 6-2.5-3-2. All assessments made by the department are presumed to be correct. Taxpayers bear the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b).

Sales Tax Information Bulletin # 8, February 9, 1990, in effect during the audit, clarified the departmental policy concerning the sales and use taxation of computers and related issues. The Information Bulletin addresses the issue of the taxability of software programs as follows:

Pre-written programs, not specifically designed for one purchaser, developed by the seller for sale or lease on the general market in the form of tangible personal property and sold or leased in the form of tangible personal property are subject to tax irrespective of the fact that the program may require some modification for a purchaser's particular computer. Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is no different than the intellectual property in a videotape or a textbook.

The department assessed use tax on two computer software programs and maintenance agreements, one concerning financial accounting and one concerning human resources, purchased by the taxpayer. Both programs are sold to many consumers. Since neither program could be used straight out of the box, they both required customization. The sellers own the copyright on the programs. The taxpayer protests the assessment of tax on the use of these computer programs.

The taxpayer's computer software purchases fit the description of pre-written or canned software programs and is taxable.

FINDING

The taxpayer's protest is denied.

II. Sales and Use Tax-Graphics Design Purchases

DISCUSSION

The taxpayer has an arts and graphics automation department. The taxpayer's clients deliver completed artwork for application onto the plastic products to the taxpayer. The arts and graphics automation department separate the colors and digitally modify the artwork so that it will look like the original after it is printed on the plastic product. This department does not create any original artwork. The color separated and digitally modified artwork is used to produce the proofs and color separations in order to generate negatives and printing plates. The plates are then placed on a printing press to print the desired image on the plastic container. The department assessed use tax on the computers and related equipment used in this pre-press graphics department.

The taxpayer protests this assessment contending that the items qualify for exemption pursuant to IC 6-2.5-5-4 as follows:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his direct use in the direct production of the machinery, tools, or equipment described in section 2 or 3 of this chapter.

The plate is a tool directly used in the direct production of the final plastic product. The issue to be determined is whether the computer and related equipment is directly used in the direct production of the tool, the printing plate.

There is no Regulation on point describing the directly used in direct production rule for a tool to be exempt. There is, however, a Regulation clarifying the parallel exemption for items directly used in direct production of tangible personal property. That Regulation, 45 IAC 2.3-5-8(c) states as follows:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

The computers and related items in issue perform the first step in transforming the customer's image into a printable image on the printing plate. The contested items are used in manipulating the customer's image in a way that allows it to be photographed and processed into a negative which is used to produce the tool used to actually print the final image on the plastic containers produced by the taxpayer. The use of the computer and the related equipment has an immediate effect on the manufacture of the printing plate.

FINDING

The taxpayer's protest is sustained.

III. Sales and Use Tax- Labels and Label Printing Equipment

DISCUSSION

During the tax period, the taxpayer purchased barcode, printing ribbons and labels. The taxpayer printed and applied bar-coded labels to the boxes containing plastic sleeves of the taxpayer's product. The department assessed use tax on these items. The taxpayer protests these assessments.

The labels are used for internal inventory and quality control purposes within the taxpayer's facility. Subsequently the labels are used to provide information that allows customers to identify the enclosed product and retrieve from storage the correct plastic containers for the day's production run. The labels also impart information necessary for the taxpayer's customers to exercise quality control. The taxpayer's customers require this information and will not accept any product without this bar code label on the box. The taxpayer packages its products, such as decorated plastic tubs or glasses, by stacking them and then encasing the stacks in plastic sleeves. Several sleeves of product are then placed in a cardboard box. During the tax period, the taxpayer printed the labels and then attached them to the cardboard boxes.

The taxpayer contends that the bar-coded labels qualify for exemption as property acquired "for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business" pursuant to IC 6-2.5-5-6. To be incorporated in the product, the labels must become part of the product during the production process.

This exemption is explained at 45 IAC 2.2-5-14(e) as follows:

. . . incorporated as a material or an integral part into tangible personal property for sale means:

- (1) The material must be incorporated into and become a component of the finished product.
- (2) The material must constitute a material or integral part of the finished product.
- (3) The tangible property must be produced for sale by the purchaser.

The taxpayer's argument that its customers require the information contained on the labels and therefore they become part of the product is not persuasive. The required packaging for the taxpayer's product is the plastic sleeves. The labels are affixed to the cardboard boxes used to store and ship the product packaged in the plastic sleeves. These cardboard boxes are not an essential part of the final product. Further, the labels contain inventory and quality control information used to benefit the taxpayer in the administration of its facility rather than as an integral part of the production of

taxpayer's product. The addition to the labels of information required by the taxpayer's customers does not transform the labels to exempt status.

The taxpayer also contends that the ribbons and ink used to print the bar code labels are exempt pursuant to IC 6-2.5-5-3(b) because they are directly used in the direct production of the taxpayer's product. Since the labels have been determined to not be part of the finished product, the ribbons and ink used in producing the labels do not impact the finished product. Therefore they are not exempt from the use tax.

FINDING

The taxpayer's protest is denied.

IV. Sales and Use Tax-Materials Handling System

DISCUSSION

The taxpayer also protests the assessment of use tax on certain materials handling equipment purchased during the tax period. This equipment is used in the process of unloading resin and blowing it to the production area. The taxpayer contends that this equipment qualifies for exemption pursuant to IC 6-2.5-5-3 which provides for the exemption of "manufacturing machinery, tools and equipment which is to be directly used by the purchaser in the direct production, manufacture, fabrication . . . of tangible personal property."

To qualify for this exemption, the item must be used in the production process. The production process is defined at 45 IAC 2.2-5-8 (d) as follows:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

The protested materials handling equipment actually blows the resin from trains into the production area. The taxpayer argues that the production process begins at the train and the blowing equipment actually is part of the manufacturing process because the blowing action sometimes changes the angle of repose of piles of the resin and fluidizes the resin. This fluidizing removes some of the clumps and removes some dust particles from the resin.

The department finds this argument unpersuasive. The blowing equipment actually transports the resins to the place in the plant where the manufacturing begins. As such the materials handling machine fits the example of taxable transportation equipment at 45 IAC 2.2-5-8 (f)(1) since it is "used for moving raw materials to the plant prior to their entrance into the production process."

FINDING

The taxpayer's protest is denied.

V. Tax Administration- Penalty

DISCUSSION

The taxpayer also protests the imposition of the ten percent (10%) negligence penalty pursuant to IC 6-8.1-10-2.1. Negligence is defined at 45 IAC 15-11-2(b) as “the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer.” Negligence is to “be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.” Id.

IC 6-8.1-10-2.1(d) allows the department to waive the penalty upon a showing that the failure to pay the deficiency was based on “reasonable cause and not due to willful neglect.” Departmental regulation 45 IAC 15-11-2 (c) requires that in order to establish “reasonable cause,” the taxpayer must demonstrate that it “exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. . . “

The taxpayer did not provide sufficient evidence that it exercised the level of care expected of the reasonable businessman in the filing and remittance of its taxes.

FINDING

The taxpayer’s protest to the imposition of the penalty is denied.